Office - Supreme Court, U.S.
FILED
NOV 1 1956
JOHN T. FEY, Clerk

IN THE

SUPREME COURT OF THE UNITED STATES.

No. 542

JOHN W. HARRISON,
Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

No. .....

CLIFFORD F. HARRISON,
Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

PETITION FOR WRIT OF CERTIORARI

To the United States Court of Appeals for the Eighth Circuit.

MARTIN A. ROSENBERG,
1724 Arcade Building,
812 Olive Street,
St. Louis 1, Missouri,
Attorney of Record for
Petitioners.

ST. LOUIS LAW PRINTING CO., 415 North Eighth Street. CEntral 1-4477.

INDEX.

Page

SUBJECT INDEX.

Petition for Writ of Certiorari 1

Opinion of the Courts Below 2

Jurisdiction of the Supreme Court of the United States 2

Questions Presented 2

Statutes Involved 3

Statement of the Case 4

Reasons for Allowance of the Writ 8

Conclusions 16

Appendix 17

Opinion of United States Court of Appeals for Eighth Circuit 17-25

Judgments of United States Court of Appeals for the Eighth Circuit 26-27

AUTHORITIES CITED.

Citations.

Bakhaus & Burke, Inc., v. Commissioner, 14 TCM 1955, 277 (August 12, 1955) 15

Harbor Plywood Corp. v. Commissioner, 143 F. 2d 780 (C. C. A. 9th Cir., 1944) 8, 10

Helvering v. Taylor, 293 U. S. 507, 55 S. C. 287 (1935) 8, 10

Pinellas Ice Co. v. Commissioner, 287 U. S. 462, 53 S. C. P. 257 14

Authorities.

Volume 12, No. 21 "The Tax Barometer", April 23, 1955, p. 834 15
Volume 12, No. 35 "The Tax Barometer", July 28, 1955, p. 1556 15
September 9, 1955, "Monthly Digest of Tax Articles" —Article entitled: "A Pitfall in Tax Free Incorporations" 15

Statutes.

Internal Revenue Code of 1939, c. 1, 53 Stat. 1:
Sec. 112 (26 U. S. C., 1952 ed., Sec. 112) 3, 4, 9, 11

IN THE

SUPREME COURT OF THE UNITED STATES.

No. .....

JOHN W. HARRISON,
Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

No. .....

CLIFFORD F. HARRISON,
Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

PETITION FOR WRIT OF CERTIORARI

To the United States Court of Appeals for the Eighth Circuit.

Come now John W. Harrison and Clifford F. Harrison and respectfully petition this Court to grant a Writ of Certiorari to review the opinion and judgment of the United States Court of Appeals for the Eighth Circuit entered on the 12th day of July, 1956, in the consolidated causes "John W. Harrison, Petitioner, v. Commissioner of Internal Revenue, Respondent," and "Clifford F. Harrison, Petitioner v. Commissioner of Internal Revenue, Respondent," affirming a judgment of the Tax Court of the United States, said judgment being in favor of the Commissioner of Internal Revenue (Respondent below), and against petitioners herein (Petitioners below).

OPINIONS OF THE COURT BELOW.

The opinion of the United States Court of Appeals for the Eighth Circuit has not yet been reported. The opinion of Tax Court is found in 24 T. C...., No. 7, and in the Record at page 39 thereof. The opinion of the Court of Appeals is not yet reported and is found in the Appendix hereto at page 17.

JURISDICTION OF THE SUPREME COURT OF THE UNITED STATES.

Judgment of the United States Court of Appeals for the Eighth Circuit was made and entered on July 12th, 1956. On August 1st, 1956, petitioners filed their "Petition for Transfer to the Court En Banc, Or in the Alternative for Rehearing." Said petition was denied on August 8th, 1956.

The jurisdiction of this Court is based upon Title 28, U. S. C., Sections 1254 (1) and 2101 (c); 28 U. S. C., Sections 1254, 2101.

QUESTIONS PRESENTED.

The questions presented by petitioners' Petition for Writ of Certiorari are as follows:

I.

Whether, after the Commissioner of Internal Revenue has made and maintained a deficiency of tax in both his deficiency notice and before the Tax Court on one theory, can the deficiency be supported upon another theory, solely upon the grounds that the taxpayer has not introduced evidence to rebut the second theory and the presumption of correctness of the Commissioner's determination prevails.

II.

The non-recognition provisions of the Internal Revenue Codes of 1939 and 1954 provide in part that no gain or loss shall be recognized if property is transferred to a corporation by one or more persons solely in exchange for stock or securities in such corporation. The term "securities" has been construed to mean long-term obligations only, in an exchange between a corporation and a corporation. The question presented is:

Whether the "securities" that may be received in a tax free exchange may be other than long-term obligations in exchanges between persons other than corporations and corporations; and specifically in exchanges between a partnership and a corporation.

STATUTES INVOLVED.

Internal Revenue Code of 1939: c. 1, 53 Stat. 1:

Sec. 112. **Recognition of Gain or Loss.**

* * * * * * *

(b) [As amended by Sec. 213 (c) of the Revenue Act of 1939, c. 247, 53 Stat. 862] **Exchanges Solely in Kind.—**

* * * * * * *

(5) **Transfer to corporation controlled by transferor.**—No gain or loss shall be recognized if property is transferred to a corporation by one or more persons solely in exchange for stock or securities in such corporation, and immediately after the exchange such person or persons are in control of the corporation; but in the case of an exchange by two or more persons this paragraph shall apply only if the amount of the stock and securities received by each is substantially in proportion to his interest in the property prior to the exchange.

Where the transferee assumes a liability of a transferor, or where the property of a transferor is transferred subject to a liability, then for the purpose only of determining whether the amount of stock or securities received by each of the transferors is in the proportion required by this paragraph the amount of such liability if under subsection (k) it is not to be considered as "other property or money") shall be considered as stock or securities received by such transferor.

* * * * * * *

(c) [As amended by Sec. 121 (d) (1) of the Revenue Act of 1943, c. 63, 58 Stat. 21] **Gain from Exchanges Not Solely in Kind.—**

(1) If an exchange would be within the provisions of subsection (b) (1), (2), (3) or (5), or within the provisions of subsection (1) of this section, if it were not for the fact that the property received in exchange consists not only of property permitted by such paragraph or by subsection (1) to be received without the recognition of gain, but also of other property or money, then the gain, if any, to the recipient shall be recognized, but in an amount not in excess of the sum of such money and the fair market value of such other property.

* * * * * * *

(26 U. S. C., 1952 ed., Sec. 112.)

STATEMENT OF THE CASE.

Respondent, the Commissioner of Internal Revenue, determined deficiencies in petitioners' income tax for the year 1947. The deficiencies assessed were assessed on the theory that some $92,400.62, designated as "drawing accounts," was a capital gain to the partners as "other property"

received in an otherwise tax-free exchange on the incorporation of their partnership business. Petitioners sought relief in the Tax Court, which affirmed the determination of the Commissioner. Petitioners duly filed their petitions for review in the United States Court of Appeals for the Eighth Circuit, which affirmed the decision of the Tax Court. The basis of Federal jurisdiction in the United States Court of Appeals, the Court of first instance, was by virtue of Sections 7482, 7483 of the Internal Revenue Code of 1954.

Most of the facts were stipulated (R. 22) and the remainder was not greatly in dispute.

The petitioners, John W. Harrison and Clifford F. Harrison, are brothers, and during the year 1946 and prior thereto operated the Harrison Lumber & Hardware Company, a partnership. The petitioners, together with their attorney, on December 23rd, 1946, executed Articles of Incorporation to incorporate their partnership business (R. 22).

The Articles of Incorporation provided that the Corporation would commence business with 1,050 shares of no par stock, and the consideration which was to be paid therefor, and the capital with which the corporation was to commence business was to be $150,000.00. The Articles of Incorporation further provided that all the said $150,000.00 had been paid up in property which was itemized in the Articles of Incorporation as follows:

Cash	$ 10,000.00
Accounts receivable	150,000.00
Inventory of lumber and millwork	250,000.00
Equipment, office furniture, etc.	1,500.00
Automotive equipment	20,500.00
Mill equipment	12,000.00
Yard wagons and equipment	11,000.00
Total	$455,000.00

The Articles of Incorporation further stated that the above listed property was subject to liabilities in the amount of $305,000.00, leaving a net value of $150,000.00. The Articles of Incorporation further stated that petitioner John W. Harrison was a subscriber to 659 shares of stock, and petitioner Clifford F. Harrison a subscriber to 390 shares of stock, and the attorney 1 share (R. 27, 28).

The stock in the corporation was issued in accordance with the Articles of Incorporation on January 3rd, 1947, the one share of the attorney being in the nature of a qualifying share so that immediately after the incorporation petitioners held 100% of the stock between themselves (R. 22, 23).

The books and records of the partnership were closed as of December 31st, 1946, at which time said books and records reflected a net worth of the partnership in the amount of $242,400.62 (R. 23).

The books and records of the corporation were opened on January 2nd, 1947, and the general journal of the corporation showed that all of the assets and all of the liabilities of the partnership had been transferred to the corporation (R. 23). The following entry appeared on the books of the corporation:

Assets.

Cash	$ 15,246.00
Accounts Receivable	159,780.64
C. Greve	142.86
Deferred Charges	7,583.81
Inventory	313,178.79
Fixed Assets	49,498.84
Improvements	2,995.65
(Total	$548,426.59)

Liabilities.

Vouchers Payable	$122,846.46
Accrued Wages Payable	3,036.65
Notes Payable	180,000.00
	(305,883.11)
J. Harrison, Drawing	44,019.92
C. Harrison, Drawing	48,523.56
	(92,543.48)
Capital Stock	150,000.00
(Total	$548,426.59)

(Totals added)

It was stipulated that the good will which attached to the partnership computed according to A. R. M. 34, 2 Cum. Bul. 31, was in the amount of $255,317.20 as of January 1st, 1947 (R. 24).

In the statement with the deficiency notice, respondent explained the adjustment to John W. Harrison's 1947 income as follows:

> "(a) It has been determined that you realized taxable income under the provisions of Section 112 (b) (5) of the Internal Revenue Code to the extent of 'other property' received upon the transfer of assets of The Harrison Lumber & Hardware Co., a partnership to a corporation of the same name, recognized in the total amount of the 'other property' received, or $44,019.92, taxable as a long term capital gain at 50% or $22,009.96."

A similar adjustment was made for Clifford F. Harrison (R. 42).

REASONS FOR ALLOWANCE OF WRIT.

I.

1) The decision of the Court of Appeals is in conflict with the decision of this Court in Helvering v. Taylor, 293 U. S. 507, 55 S. C. 287 (1935), as well as the decision by the Court of Appeals for the Ninth Circuit in Harbor Plywood Corp. v. Commissioner, 143 F. 2d 780 (C. C. A., 9th Cir., 1944).

This Court's decision in Helvering v. Taylor, supra, held that the Commissioner's determination when it was shown to be without rational foundation and excessive, would not be enforced because the taxpayer did not prove he owed nothing, or if liable at all, the taxpayer did not show the correct amount.

Likewise, the Ninth Circuit in Harbor Plywood Corp. v. Commissioner, supra, held that reasons not advanced by the Commissioner in his deficiency notice or before the Tax Court in support of a deficiency assessment would not be considered where the taxpayer had been deprived of an opportunity to present evidence material thereto.

2) The Commissioner's actual determination in each case is found in the Findings of Fact of the Tax Court; it was as follows:

> "In the statement with the deficiency notice respondent (Commissioner) explained the adjustment to John W. Harrison's 1947 income as follows:
>
> (a) It has been determined that you realized taxable income under the provisions of Section 112 (b) (5) of the Internal Revenue Code to the extent of 'other property' received upon the transfer of assets of The Harrison Lumber & Hardware Co., a partnership to a corporation of the same

> name, recognized in the total amount of the 'other property' received, or $44,019.02, taxable as a long term capital gain at 50%, or $22,009.96.
>
> "A similar adjustment was made for Clifford F. Harrison" (R. 42).

This was the determination made by the Commissioner. The issue that the Commissioner drew by this determination was, that the drawing accounts were neither "stock or securities" under Section 112 (b) (5), but rather were "other property." The Commissioner in order to show that a gain had been realized, at least to the extent of the "other property" received, contended that the alleged good will of the partnership was in excess of $255,000 (R. 24) and hence a gain was realized. Why the Commissioner insisted on this false and erroneous theory is unknown, as the Tax Court pointed out (with which the Court of Appeals did not quarrel) good will was not important to the decision of the case (R. 47).

What is important is that the Commissioner made no issue whatsoever in his determination, or at the trial of the cause, as to the adjusted basis of the partnership assets. In fact, the Commissioner's own agent testified, on cross-examination, that the net value of the partnership assets was $242,000.00 (R. 38). Further, the Commissioner stipulated that at the time of the exchange the books and records of the partnership reflected a net worth of $242,000.00 (R. 23). At no time, either in the Commissioner's determination, or at trial, did the Commissioner quarrel with, or imply, that the basis of the assets in petitioner's hands was other than as reflected upon the books of the partnership. No theory of taxable income by virtue of appreciation of assets was advanced until after the trial stage.

The basis of the assets, not being in question, no evidence was introduced by either party other than the values

reflected by the petitioner's books, which were part of a joint stipulation by both parties (R. 22-27). It was only in the opinion of the Tax Court (R. 42-47), after the Commissioner's theory of good will had been rejected, that petitioners were apprised of the fact that a theory of gain based upon the valuation of the assets was an issue.

While it is true there is a presumption of correctness as to the Commissioner's determination, which the taxpayer must overthrow, if the taxpayer is to prevail; certainly, that presumption of correctness should not attach to any facts or theory that the Commissioner does not put in issue. Nor can it be said that implicit in the determination of the Commissioner, as set out above, was there a recognition by him of a basis for the assets in petitioner's hands of $150,000.00 only—the amount of the capital stock, as the Court of Appeals held (Opinion 9). The record is bare that the Commissioner ever implied such or proceeded upon any theory other than that of good will.

If the decision of the Eighth Circuit in this cause is allowed to stand, the principles upon which the decisions of Helvering v. Taylor, supra, and the Harbor Plywood Corp. v. Commissioner, supra, rest, will in effect, be abandoned. The decision of the Eighth Circuit permits the Tax Court and the Court of Appeals to affirm the Commissioner upon theories that he himself at no time raised, argued or presented, prior to or during trial of the cause. It permits affirmance simply upon the basis that another theory could be implied and the taxpayer should have rebutted it even though the Commissioner himself did not raise it.

By the decision of the Eighth Circuit the taxpayer is not only required to supply evidence upon the issues actually pressed, but, to protect himself, is required to clog the record with evidence which is necessary to rebut any theory that the Tax Court or Court of Appeals may imply

was present in the Commissioner's determination. In short, no longer will the issues be determined by the Commissioner in the presentation of his case, but rather by the implication, given in hindsight, by the Courts.

If this Court takes the position that the burden is on the taxpayer to defeat the Commissioner's assessment on every conceivable theory upon which a tax could be assessed, then at the very least, this cause should be reversed and remanded to permit petitioners the opportunity to comply with the new holding, since all existing authority is to the contrary.

II.

1. This is a case of first impression concerning the tax consequences occasioned by the change in form of a business, from a partnership to a corporation.

It has long been the policy of the Congress in the field of taxation to permit a change in business form without the recognition of any gain or loss so long as the change is one of form only. The gain or loss is merely postponed until a substantial change in the interest occurs. As the pertinent provision of the Revenue Code here concerned states it: No gain or loss is recognized if the property transferred to a corporation is solely in exchange for stock or securities in such corporation. The stock or securities received, of course, must be held substantially in proportion to the interest in the property held prior to the exchange. Sec. 112 (b) (5), Internal Revenue Code of 1939.

The question here raised is the construction of the phrase "stock or securities" in an exchange between a partnership and a corporation. The meaning of this phrase is quite clear from numerous decisions, and reason itself, where the exchange is one between two corporations. In this event, the stock received must be of much the same nature as held in the prior corporation. The

securities received, if any, must be long term in nature. If anything other is permitted to be received, the change cannot be said to be truly one of form only. Actually, when anything other than stock or long term securities is received, there is a shifting of proprietary interests and at least a partial sale is taking place. If short term obligations are received, they simply take the place of cash, and represent deferred payments for proprietary interests formerly held. To permit this would be to defeat the very purpose of the non-recognition provisions.

When a partnership is incorporated, however, or as the Internal Revenue Code terms it: an exchange is made between a partnership and a corporation, the problems encountered are different from those in an exchange between a corporation and a corporation. In the case of a partnership, unlike the case of a corporation, the proprietary interest, the net worth, is treated as neither an asset nor a liability. The net worth, the difference between the assets and liabilities, is simply the interest of the partners. This interest, the net worth, arises basically from either an accumulation of profits left in the business, or an appreciation of assets, or both. In regard to accumulated profits, the tax on this is paid each taxable year by the individual partners at ordinary income rates. Thereafter these profits may be withdrawn during the continuation of the partnership by the partners at will, without further tax liability. In regard to the appreciation of assets, if any, the tax will be paid at ordinary rates as the individual assets are sold, or taxed as a capital gain when the entire interest in the business is sold.

Another difference is that in a partnership the partners, of course, are not paid salaries. The partners simply draw against their respective interests in the partnership, the net worth. These "draws" are recorded in their respective drawings accounts, which may or may not be in balance, depending upon the needs of the individual

partners. Almost always, the net worth is invested in the business in the form of inventory or other assets, and not kept in the form of cash.

When a partnership is incorporated, and the individual partners have actually drawn all they wish at that particular time, no problem arises at the time of exchange. The exchange can be made and the partners can accept stock of equal value for their respective interests in the partnership. This is, however, an ideal state, and seldom exists. In many cases the "draws" will be out of balance, or the partners may not have fully drawn the amounts needed due to various reasons; for instance, the business may be short of cash, the cash available may be needed for working capital, the partners' own needs may not be immediate, or any other of a number of reasons. How then, to effectuate the exchange, and yet preserve the partners' rights to their respective drawing accounts? Where a purely corporate exchange occurs, the problem is not present, since in a comparable situation in the case of a corporation, the item "drawing accounts" would be a liability account of salaries and wages owed and could be assumed by the new corporation. In the case of a partnership, however, the "drawing accounts" are carried neither as a liability or as an asset. On the one hand, if stock is taken for the "drawing account," then to attain the result desired, the stock must be sold. This, of course, results in the giving up of a substantial proprietary interest besides presenting the real and practical problem of finding a market for the stock. If, on the other hand, long term securities are taken in exchange for the "drawing accounts," no use can be made of the funds in the immediate future, which is the very object sought. Also the question of marketability again presents itself.

In the instant case, petitioners were faced with this problem, and solved it in the only practical and logical way. Petitioners, before the exchange, had "drawing

accounts" in the partnership totaling $92,000.00. The net worth of the partnership was $242,000.00 (R. 23, 24). At the time of the exchange all of the assets and liabilities of the partnership were transferred into the new corporation in exchange for $150,000.00 of stock, and $92,000.00 in "drawing accounts" liabilities from the new corporation to the former partners (R. 24). It was admitted that the $92,000.00 liability of the new corporation to the former partners was a demand account and not in the nature of a long-term obligation.

The Tax Court and the Court of Appeals both held that "the demand drawing accounts" of $92,000.00 did not constitute "securities" within the meaning of that term, as the term had been construed by this Court in Pinellas Ice Co. v. Commissioner, 287 U. S. 462, 53 S. C. P. 257. In short, both Courts held that regardless of the inherent difference in an exchange between a corporation and a corporation, and an exchange between a partnership and a corporation, the receipt of anything other than stock or long-term securities constituted "boot" and, as such, demanded imposition of a long-term capital gain to the extent of the "other property received," i. e., the $92,000.00 drawing accounts.

2. The decision of the Court of Appeals in the instant case is the first appellate decision upon the construction of the term "securities" where a partnership is involved in an exchange under the non-recognition provisions of the Internal Revenue Code. It was a case of first impression. It is a case which should and ought to be considered by this Court. It is not without importance.

The incorporation of a partnership is a common occurrence. It occurs daily. It is a natural and logical step as a small business grows. True, the incorporation of any particular partnership may be of little consequence to the total effect on the economic affairs of the Nation, but this

is not the true test of the importance of the question raised. The importance of the question is in its continued and ever occurring nature, its cumulative effect, its ever presence. And the fact that it is a problem of small business only heightens its importance. The small business, because of its smallness, simply cannot afford, from an economic standpoint, an unsettled state of the law. The fact that the expense for the employment of experts to find some artificial way to effect compliance to form rather than compliance in substance can be charged off as a legitimate business expense is of little help when the business cannot stand the expense. Further, the very apparent simplicity of the problem of incorporating a business is a hidden snare unless some reasonable distinction is made in interpreting the law so that the substance of the transaction and not the form governs. The interpretation of the term "securities" and its meaning in relation to the non-recognition provisions must be based upon the nature of the exchange; otherwise it is meaningless.

The importance attached to the decisions of both The Tax Court and the Court of Appeals is attested to by the wide discussion of them among tax practitioners, and in tax publications. At least three articles, pointing out the consequences and problems raised by these opinions have appeared in print even prior to the filing of this petition.[1] Likewise, the tax services have sounded a "caveat."

The only other decision which has considered this problem is in conflict. Bakhaus & Burke, Inc., v. Commissioner, 14 T. C. M. 1955—227 (August 12, 1955). The Bakhaus decision was subsequent to the Tax Court's decision in this

[1] Volume 12, No. 21, "The Tax Barometer," April 23, 1955, ¶ 834;
Volume 12, No. 35, "The Tax Barometer," July 28, 1955, ¶ 1536;
September 9, 1955, "Monthly Digest of Tax Articles"—article entitled "A Pitfall in Tax Free Incorporation."

case, but prior to the consideration of this case by the Court of Appeals below. Although the Bakhaus decision was cited to the Court of Appeals it received no comment or mention and adds to the problems in this field. Nor is this problem moot; substantially the same provision exists in the new Revenue Act.

Certainly it can be said that persons, other than corporations, should have and receive the benefits of the non-recognition provisions as the Congress intended them. They should not be deprived of their right to make changes in the forms of their businesses solely because of interpretations and restrictions which can apply with all reason and justice only to the corporate entity.

The sheer unjustness, and the triumph of form over substance becomes even more pronounced when it is remembered that if the cash had been available, the partners could have withdrawn the $92,000.00, then completed the exchange, and incurred no tax liability of any nature or kind whatsoever either as individuals, partners or as stockholders.

CONCLUSION.

For the reasons set forth petitioners pray that a Writ of Certiorari be granted to review the judgment of the United States Court of Appeals for the Eighth Circuit.

Respectfully submitted,

MARTIN A. ROSENBERG,
1724 Arcade Building,
812 Olive Street,
St. Louis 1, Missouri,
Attorney of Record
for Petitioners.

APPENDIX.

(Opinion.)

UNITED STATES COURT OF APPEALS
FOR THE EIGHTH CIRCUIT.

No. 15,414.

John W. Harrison, Petitioner,
vs.
Commissioner of Internal Revenue, Respondent.
} Petition to Review Decision of the Tax Court of the United States.

No. 15,415.

Clifford F. Harrison, Petitioner,
vs.
Commissioner of Internal Revenue, Respondent.
} Petition to Review Decision of the Tax Court of the United States.

[July 12, 1956.]

Martin A. Rosenberg and Rodney Weiss (Gilbert Weiss with them on the brief), for Petitioners.

Melva M. Graney, Attorney, Department of Justice (H. Brian Holland, Assistant Attorney General, Ellis N. Slack, Lee A. Jackson, and Grant W. Wiprud, Attorneys, Department of Justice, with her on the brief), for Respondent.

Before Sanborn, Johnsen, and Van Oosterhout, Circuit Judges.

Johnsen, Circuit Judge.

Deficiency assessments by the Commissioner of Internal Revenue against two taxpayers, for the calendar year 1947, were upheld by the Tax Court, 24 T. C. No. 7, and each of the taxpayers has petitioned for review.

The first contention made by petitioners is that the exchange transaction, on which the assessments were predicated, occurred in 1946, and not in 1947, so that any liability which they might have had on account thereof, as an "omission from gross income", was barred by not having been asserted against them, under §275 (c) of the Internal Revenue Code of 1939, 26 U. S. C. A., "within 5 years after the return was filed." The Commissioner concedes that, if the transfer involved occurred in 1946, instead of 1947, the tax liability is barred.

Petitioners' second contention is that in any event the transaction had not given rise to any realization of capital gain by them, so that there existed no basis for a tax to be assessed in relation to it.

The situation is one in which petitioners incorporated their previous partnership business, the Harrison Lumber & Hardware Co.; made transfer at some point to the corporation of all the assets of the partnership, subject to its liabilities; and had the corporation in return issue to them the whole of its capital stock,[1] as well as set up a credit on its books in favor of each of them, as individual drawing accounts, in a total amount for the two of $92,534.48.[2] It

---

[1] One share of stock was put in the name of the partners' attorney, in qualification of his status as an incorporator and as a director, but it was stipulated that the share actually was owned by one of petitioners.

[2] This amount, as set up on the books of the corporation, was $142.86 in excess of the difference between the $242,400.62 net worth value of the partnership's assets and the $150,000 value basis on which the stock was issued. The difference is not explained by the record, but apparently it bore some relationship to the share of stock put in the name of the attorney for the partners, since it cor-

was these drawing accounts, in their full amount—the Tax Court having taken them at face value[3]—for which petitioners were held to have a tax liability, as constituting capital gain realized by them out of the transaction.

On petitioners' first contention—that of the statute of limitations—they argue that the Tax Court should have recognized the transaction between the partnership and the corporation as being one that had occurred in 1946 and not 1947, in that the Articles of Incorporation were executed on December 23, 1946 and filed in the office of the Secretary of State of Missouri on December 28, 1946, with a Certificate of Incorporation being duly issued by that officer to the corporation on the same date; that under the statutes of Missouri, V. A. M. S., § 351.075, the corporation acquired legal existence at that time and thus became possessed of capacity to hold title to property; that it accordingly on that date (if not before) became vested with the title to the assets of the partnership listed in the Articles of Incorporation, which property the Articles declared had "paid up," in its fixed net value of $150,000, the amount of the capital with which the corporation was to commence business; and that this passing of title from the partnership to the corporation in 1946 was not only further demonstrated, but was also rendered legally conclusive as a matter of Missouri law, by the affidavit to the Articles on the part of petitioners, as incorporators and in their status of then owners, certifying in connection with the incorporation as to their knowledge of the property "taken in payment of the shares of the Corporation," which was described in the Articles, and as to the property having the value placed upon it in the Articles.

---

responded exactly to the book value of the share, and since a charge in the same amount was put upon the books of the corporation against the attorney. This accounting confusion, however, is not claimed by either party to be of any significance here and so it will be ignored.

[3] There is no contention here that the value of the drawing accounts at the time was less than their face amounts.

The Tax Court recognized that the corporation had acquired legal existence in 1946 but said that Missouri law did not treat recitations in articles of incorporation as conclusive of stock subscriptions having in fact been paid—citing **Raleigh Investment Co. v. Bunker,** 285 Mo. 440, 227 S. W. 121, and **Yardley v. Caruthersville Motor Co.,** 225 Mo. App. 321, 35 S. W. 2d 971.

Against such implications on the time of transfer by the partnership as the Articles might prima facie have, the Tax Court pointed out that the evidence undisputedly showed that the partnership actually closed its books as of December 31, 1946, and not as of an earlier date, and that the corporation did not open its books until January 2, 1947, with the property received by it from the partnership being set up on its records as corporate assets under that date. With no formal instruments of transfer having been used by the parties, the facts just stated seemed to the Tax Court persuasive that the partnership had continued to operate the business and had retained dominion of the assets as owner through the remainder of the year 1946, and that the assets had not in fact been passed over by the partnership to the corporation in ownership and possession until January 2, 1947.

Beyond the circumstances of the continued operation of the business by the partnership until 1947 and of the lack of records to show any property ownership by the corporation until January 2, 1947, the Tax Court found additional support for its conclusion, that the transfer had not been culminated in 1946, in the large discrepancy which existed between the amount and the categories of property set up on the books of the corporation on January 2, 1947, as being transferred from the partnership, and the amount and the categories of property listed in the Articles under date of December 23, 1946, as being intended to be transferred to the corporation.

Property in the amount of $548,426.59 was shown on the corporation's records as having been received by it, while property in the amount of $455,000 only was listed in the Articles of Incorporation as being intended to be transferred from the partnership. Thus, beyond the property listed in the Articles of Incorporation, assets in the amount of over $90,000, not covered by the recitals of the Articles, had at some time been transferred to the corporation, with no other indication that this was to be done, or when it had occurred, except the entry appearing upon the corporation's records dated January 2, 1947. Moreover, the general categories of property set up on the corporation's records did not wholly conform in their characterizations or descriptions to the language which had been used in the Articles of Incorporation.

Petitioners' argument that the transfer of the property was required to be held to have occurred in 1946 is grounded primarily upon the case of **Bondurant v. Raven Coal Co.**, Mo. App., 25 S. W. 2d 566, which they view as holding that, where incorporators recite in their articles of incorporation that certain described assets, of which they are the owners, have been paid in by them as initial capital, the recital is conclusive against them and operates to transfer title to the corporation as a matter of law.

The Court's opinion says (p. 573): "If Mills and Mays owned this land at the time they incorporated the company and they stated in the articles of incorporation that said land was the property of the corporation and in the hands and custody of the first board of directors, they being two of the four directors, then the land became the property of the corporation as a matter of law. Such a title in the corporation would be good upon the ground of estoppel alone. But the recitations in the articles of association were more than an estoppel. They constituted a declaration of a dry trust, which is as good a conveyance as a quitclaim or warranty deed in the usual form."

On whatever basis, or to whatever extent, or in whatever form, the Court by this holding may have intended that a declaration on the part of the incorporators in their articles of incorporation should operate to vest rights or title to property in the corporation, we do not believe that such a rule of legal vesting as the Court may have intended to lay down would be given any extension by the Missouri courts, to make it have application to property which was not legally described and identifiable on the face of the articles.

Here, as we have said, the Articles, as drawn and filed, listed certain categories of assets in the amount or value of $455,000, and not these categories with others (as set up on the corporation's records) in the total amount or value of $548,426.59, as constituting the property, intended to be or having been transferred to the corporation. There accordingly was property in an amount of more than $90,000 which the Articles did not on their face in any way purport to cover.[4] With no obligation on the part of petitioners shown by the Articles to make transfer of this excess property to the corporation; with petitioners not having closed the business and books of the partnership until December 31, 1946; and with the record before us showing that all the assets transferred had been set up on the corporation's records as of January 2, 1947—we think that the **Bondurant** case was not legally controlling of the present situation, and that the Tax Court properly could conclude, as it did, that the transfer of assets in their whole was not completed and given effect between the parties during the year 1946, so that the question of tax liability connected with it was not, as contended by petitioners, barred by the statute of limitations.

On petitioners' second contention, the gist of the argument made is that they could not be held to have realized

[4] Thus, the Articles did not even state that all of the partnership assets were to be transferred to the corporation.

any gain from the drawing accounts set up in their favor on the corporation's records, since the drawing accounts did not amount to "boot" in the situation, but "all that was done here was that the corporation assumed a liability of the partnership (the liability of the partnership to the partners) along with the liabilities of the partnership to others." But no such liability had been set up on the partnership's records, and there is nothing in the record to show that the partnership had any such liability in fact. To the contrary, it was stipulated that at the time the books and records of the partnership were closed, the partnership had a net worth of $242,400.62—which, as has been noted,[5] corresponded to the sum of the value of the capital stock and of the drawing accounts, that petitioners received from the corporation.

Petitioners thus received, in exchange for the property transferred to the corporation, stock and drawing accounts in the corporation. Under section 112 (b) (5) of the Internal Revenue Code of 1939, 26 U. S. C. A., "No gain or loss shall be recognized if property is transferred to a corporation by one or more persons solely in exchange for stock or securities in such corporation, and immediately after the exchange such person or persons are in control of the corporation * * *."

But the demand drawing accounts which petitioners received from the corporation did not constitute "securities," within the meaning of that term as used in § 112 (b) (5), for purposes of non-recognition of gain or loss. Cf. **Pacific Public Service Co. v. Commissioner,** 9 Cir., 154 F. 2d 713; **Neville Coke & Chemical Co. v. Commissioner,** 3 Cir., 148 F. 599; **Lloyd-Smith v. Commissioner,** 2 Cir., 116 F. 2d 642; **Pinellas Ice Co. v. Commissioner,** 287 U. S. 462, 53 S. Ct. 257, 77 L. Ed. 428. They were entitled to be regarded as "other property," within the provision of

[5] See footnote 2, supra.

§ 112 (c) (1) of the Code, for the recognizing of gain, that "If an exchange would be within the provisions of subsection (b) * * * (5) * * * of this section if it were not for the fact that the property received in exchange consists not only of property permitted by such paragraph * * * to be received without the recognition of gain, but also of other property or money, then the gain, if any, to the recipient shall be recognized, but in an amount not in excess of the sum of such money and the fair market value of such other property."

How there came into the transactional picture, within a period of ten days from the time that the articles of incorporation were drawn, an amount of assets having a value of more than $90,000 over the property listed in the Articles, is not made clear. It would hardly be required to be accepted that the Article had inadvertently contained an under-estimation of quantity and value, as against the facts that a decidedly substantial difference was involved, and that petitioners had certified under positive oath, for purposes of the incorporation, that "they knew the property described" in the Articles, and that "the value placed on the same is the actual cash value of said property." Besides, it would not seem convincing that such an inadvertent omission should occur, when the partnership maintained books and records, as the reference to them in the stipulation indicates.

What the net worth was that appeared upon the partnership books on December 23, 1946, the record does not show. We only know that when the books were closed as of December 31, 1946, they "reflected a net worth of the partnership in the amount of $242,400.62." An increase may have been made in the value previously carried for the assets, in order to reflect their actual worth at the time the partnership ceased its business. But we need not speculate upon that question. Whatever may be the actual explanation of the discrepancy and how it occurred,

when the Commissioner made the deficiency assessments against petitioners that he did, subjecting them to a liability for capital gain on the basis of the drawing accounts received by them, there was implicit in the determination which he so made a recognition by him of a basis for the assets in petitioners' hands of $150,000 only—the amount of the capital stock.

If there was any right to claim that the assets had in fact a basis to petitioners, for tax purposes, of $242,400.62, so that no capital gain would be capable of existing from a sale of the property for that figure, or from an exchange of it on that basis for "other property" of the same value, then petitioners, in seeking a redetermination from the Tax Court, should have offered evidence which would demonstrate the Commissioner's lack of right to use the basis which he impliedly did, and which would provide ground for the Tax Court to determine what the actual basis was. This petitioners did not do.

As against the presumption attaching to a determination by the Commissioner, petitioners are not in a position to complain of the Tax Court's sustaining of that determination in the present situation. A taxpayer who challenges the factual basis of a deficiency assessment by the Commissioner must produce evidence before the Tax Court which provides ground sufficient to enable the Tax Court to pass upon the particular fact and so to impose upon it the duty of making the determination independently. **National Weeklies, Inc., v. Commissioner**, 8 Cir., 137 F. 2d 39, 42.

The decision of the Tax Court in each of the two cases is affirmed.

A true copy.

Attest:

Clerk, U. S. Court of Appeals, Eighth Circuit.

(Judgment in Cause No. 15414.)

United States Court of Appeals for the
Eighth Circuit.

No. 15414 — September Term, 1955.
Thursday, July 12, 1956.

John W. Harrison,
Petitioner,

vs.

Commissioner of Internal Revenue.

Petition to Review Decision of The Tax Court
of the United States.

This cause came on to be heard on the petition to review the decision of The Tax Court of the United States entered April 21, 1955, determining that there is a deficiency in the income tax of the petitioner for the year 1947, and was argued by counsel.

On Consideration Whereof, It is now here Ordered and Adjudged by this Court that the decision of the said tax Court in this cause be, and the same is hereby, affirmed.

And it is further Ordered by this Court that the said petition to review in this cause be, and the same is hereby, dismissed.

July 12, 1956.

(Judgment in Cause No. 15415.)

United States Court of Appeals for the
Eighth Circuit.

No. 15415 September Term, 1955.
Thursday, July 12, 1956.

Clifford F. Harrison,
Petitioner,

vs.

Commissioner of Internal Revenue.

Petition to Review Decision of The Tax Court
of the United States.

This cause came on to be heard on the petition to review the decision of The Tax Court of the United States entered April 21, 1955, determining that there is a deficiency in the income tax of the petitioner for the year 1947, and was argued by counsel.

On Consideration Whereof, It is now here Ordered and Adjudged by this Court that the decision of the said Tax Court in this cause be, and the same is hereby, affirmed.

And it is further ordered by this Court that the said petition to review in this cause be, and the same is hereby, dismissed.

July 12, 1956.

INDEX

	Page
Opinions below	1
Jurisdiction	1
Questions presented	2
Statute involved	2
Statement	3
Argument	5
Conclusion	7

CITATIONS

Cases:	
Harbor Plywood Corp. v. *Commissioner*, 143 F. 2d 780	7
Helvering v. *Taylor*, 293 U. S. 507	7
Lloyd-Smith v. *Commissioner*, 116 F. 2d 642	5
Neville Coke & Chemical Co. v. Commissioner, 148 F. 2d 599	5
Pacific Public Service Co. v. *Commissioner*, 154 F. 2d 713	5
Pearce v. *Commissioner*, 315 U. S. 543	6
Pinellas Ice Co. v. *Commissioner*, 287 U. S. 462	5
Statutes:	
Internal Revenue Code of 1939:	
Sec. 111 (26 U. S. C. 1952 ed., Sec. 111)	6
Sec. 112 (b) (26 U. S. C. 1952 ed., Sec. 112 (b))	2, 5
Sec. 112 (c) (26 U. S. C. 1952 ed., Sec. 112 (c))	3, 6
Sec. 113 (26 U. S. C. 1952 ed., Sec. 113)	6
Sec. 181 (26 U. S. C. 1952 ed., Sec. 181)	5
Sec. 182 (26 U. S. C. 1952 ed., Sec. 182)	5

409147—56

In the Supreme Court of the United States

OCTOBER TERM, 1956

No. 542

JOHN W. HARRISON, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

CLIFFORD F. HARRISON, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The findings of fact and opinion of the Tax Court (R. 39–47) are reported at 24 T. C. 46. The opinion of the Court of Appeals (Pet. 17–25) is reported at 235 F. 2d 587.

JURISDICTION

The judgments of the Court of Appeals were entered on July 12, 1956. (Pet. 26–27.) A timely petition for rehearing was filed on August 1, 1956, and

denied on August 8, 1956. The petition for a writ of certiorari was filed on November 1, 1956. The jurisdiction of this Court is invoked under 28 U. S. C., Section 1254.

QUESTIONS PRESENTED

On the incorporation of taxpayers' partnership business, the partnership assets were transferred to a corporation in exchange for the issuance of all the corporation's capital stock to taxpayers and drawing accounts in taxpayers' favor. The questions presented are:

1. Whether the drawing accounts constituted "other property" under Section 112 (c) (1) of the 1939 Internal Revenue Code, rather than "securities" under Section 112 (b) (5), so that the exchange transaction is taxable to the extent of the gain represented by the drawing accounts.

2. Whether the drawing accounts represented realized gain in the amounts thereof.

STATUTE INVOLVED

Internal Revenue Code of 1939:

> SEC. 112. RECOGNITION OF GAIN OR LOSS.
>
> * * * * *
>
> (b) *Exchanges Solely in Kind.*—
>
> * * * * *
>
> (5) *Transfer to corporation controlled by transferor.*—No gain or loss shall be recognized if property is transferred to a corporation by one or more persons solely in exchange for stock or securities in such corporation, and

immediately after the exchange such person or persons are in control of the corporation; * * *.

* * * * *

(c) [as amended by Sec. 121 (d) (1) of the Revenue Act of 1943, c. 63, 58 Stat. 21] *Gain from Exchanges Not Solely in Kind.*—

(1) If an exchange would be within the provisions of subsection (b) (1), (2), (3), or (5), * * * if it were not for the fact that the property received in exchange consists not only of property permitted by such paragraph * * * to be received without the recognition of gain, but also of other property or money, then the gain, if any, to the recipient shall be recognized, but in an amount not in excess of the sum of such money and the fair market value of such other property.

* * * * *

(26 U. S. C. 1952 ed., Sec. 112.)

STATEMENT

The undisputed facts are as follows:

Taxpayers are brothers who were in business together as partners and, at the end of 1946, incorporated that business. (R. 40.) The articles of incorporation, dated December 23, 1946, provided for the issuance of all of the capital stock of the corporation to taxpayers for $150,000, to be paid in property of the partnership listed at a net value of $150,000.[1] (R. 27–29, 40.) However, when the partnership books were closed on December 31, 1946, they reflected a

[1] One share of stock was issued to Clifford Greve (R. 28) but it is stipulated that he held that share as a straw party for taxpayer John W. Harrison (R. 23).

partnership net worth of $242,400.62. The entries on the corporate books as of January 2, 1947, show a transfer of assets of the partnership to the corporation in the total amount of $548,426.59, subject to liabilities in the same amount which included capital stock listed at $150,000 and two drawing accounts, one in favor of taxpayer John W. Harrison in the amount of $44,019.92 and one in favor of taxpayer Clifford F. Harrison in the amount of $48,523.56. (R. 41.) Thus, partnership assets of the net value of $242,543.48 were transferred to the corporation in exchange for (1) $150,000 of capital stock issued to taxpayers and (2) the two drawing accounts in taxpayers' favor totaling $92,543.48.[2]

The Commissioner recognized the transfer of the partnership's assets to the corporation as a tax-free exchange of property for stock or securities within the meaning of Section 112 (b) (5) and (c) (1) of the 1939 Internal Revenue Code, except to the extent of the amounts of the drawing accounts in taxpayers' favor. As to those, the Commissioner determined deficiencies on the ground that the drawing accounts were "other property" received on the exchange which constituted realized taxable income in the amounts stated, *i. e.*, $44,019.92 as to taxpayer John W. Harrison and $48,523.56 as to taxpayer Clifford F. Harrison. (R. 42.)

---

[2] The $142.86 difference in net assets listed as transferred to the corporation ($242,543.48) and as listed in the closing entries on the partnership books ($242,400.62) (R. 41) is not expressly explained by the record but is not claimed by either party to have significance.

The Tax Court and the court below both sustained the Commissioner's deficiency determinations. (R. 44–47; Pet. 22–25.)

ARGUMENT

Taxpayers assert that the decision below involves an important question (Pet. 11–16) and is in conflict with other decisions (Pet. 8–11). Neither assertion is correct.

1. It is well settled that unsecured, demand, drawing accounts do not constitute "securities" within the meaning of Section 112 (b) (5) of the 1939 Internal Revenue Code, *supra*, pp. 2–3. See *Lloyd-Smith* v. *Commissioner*, 116 F. 2d 642 (C. A. 2d); cf. *Pinellas Ice Co.* v. *Commissioner*, 287 U. S. 462; *Pacific Public Service Co.* v. *Commissioner*, 154 F. 2d 713 (C. A. 9th); *Neville Coke & Chemical Co.* v. *Commissioner*, 148 F. 2d 599 (C. A. 3d). Taxpayers admit as much "where the exchange is one between two corporations" (Pet. 11; see also Pet. 14), but state that it is important for the Court to decide what constitutes "securities" when the exchange is between a partnership and a corporation (Pet. 12). No exchange between a corporation and a partnership is or could be involved here. As partners, taxpayers are treated as individuals (see Sections 181 and 182 of the Code (26 U. S. C. 1952 ed., Secs. 181, 182)), and they are invoking Section 112 (b) (5) in the capacity of "persons" who made an exchange of property. The meaning of "securities" in Section 112 (b) (5), as developed in the decisions, is fully applicable to exchanges by individuals (see *Lloyd-Smith v. Commissioner, supra*) and, therefore, to taxpayers' exchange.

2. Taxpayers' allegations of conflict (Pet. 8) are apparently based on the premise that the court below affirmed the Commissioner's deficiency determinations on a theory never put in issue by the Commissioner (see Pet. 8–11). The premise is unsound.

Under Section 112 (c) (1), *supra*, p. 3, which is applicable to the exchange, taxpayers' gain on the exchange, if any, is "recognized" and taxable to the extent of the fair market value of the "other property" (the drawing accounts) they received. Their gain was the amount by which the value of what they received (stock and drawing accounts) exceeded their adjusted basis for the partnership property they transferred to the corporation. See Sections 111 and 113 of the Code (26 U. S. C. 1952 ed., Secs. 111 and 113). The Commissioner in his deficiency notices to taxpayers determined that the entire amounts of the drawing accounts, $44,019.92 as to taxpayer John W. Harrison and $48,523.56 as to taxpayer Clifford F. Harrison, are "recognized" and "realized taxable income" under Section 112 (b) (5) and (c) (1). (R. 10, 19, 42.) It was implicit in these determinations, as the court below stated (Pet. 25), that taxpayers' basis for the partnership assets was only $150,000, the amount of the stock they received on the exchange. If they had any ground for contending that their basis was more than $150,000, so that their gain on the exchange was not in the amount determined by the Commissioner, they should have pleaded the point and offered evidence in support. As the court below held (Pet. 25), the burden was upon them to show that the Commissioner's deficiency determinations were incorrect. *Pearce* v. *Commissioner,* 315

U. S. 543, 546. However, taxpayers offered no evidence to show, and indeed have never even contended, that their basis for the partnership assets was more than $150,000. The "basis" question was injected into the case only when, in the court below, taxpayers seemed to assume, as they apparently still do (see Pet. 9, 12), that the cost basis of the assets was necessarily the same as the net value of the assets. The assumption is without foundation.

The conflict in decisions asserted by taxpayers accordingly rests on principles (see Pet. 8) which are inapposite here. Unlike *Helvering* v. *Taylor,* 293 U. S. 507, this case does not involve a deficiency determination of the Commissioner which has been shown to be excessive and without rational foundation. Similarly, *Harbor Plywood Corp.* v. *Commissioner,* 143 F. 2d 780 (C. A. 9th), would be pertinent only if, contrary to fact, taxpayers had claimed a certain basis for the partnership assets and the Commissioner had accepted that basis in his deficiency notice.

CONCLUSION

The decision below is correct and involves no conflict of decisions or important question of law. The petition for a writ of certiorari should be denied.

Respectfully submitted,

J. LEE RANKIN,
Solicitor General.
CHARLES K. RICE,
Assistant Attorney General.
MELVA M. GRANEY,
Attorney.

NOVEMBER, 1956.

U. S. GOVERNMENT PRINTING OFFICE: 1956